Consultation Response

Digital Securities Sandbox (UK)

August 2023

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **HM Treasury's Consultation on the first Financial Market Infrastructure Sandbox.** AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

Executive Summary

AFME members consider the development of the Digital Securities Sandbox (DSS) as a positive step forward in facilitating experimentation with new technologies in a safe and controlled manner. We have welcomed the open and thoughtful approach of UK authorities in their engagement with market participants. It is positive that the industry input to date, including reflections on potential limitations of analogous initiatives in other jurisdictions, has been reflected in the principles outlined by HMT. We welcome the proposed flexibility, the ambitious approach towards capacity and limits, and the aspiration to ensure a smooth exit process. We emphasise that further details on how these principles will be enacted is important, and welcome the opportunity for continued engagement with UK authorities on this topic. We also encourage HMT to ensure the DSS is appropriately resourced to ensure that the benefits of a dynamic and flexible regime can be fully realised.

Given that current industry adoption of new technologies such as DLT remains in its relative infancy, the UK authorities should prioritise flexibility as a key design principle of the Sandbox. We support the broadest possible scope of instruments, activities and settlement assets. As DLT adoption matures, we anticipate that further use cases and business models may arise. As such, we believe the Sandbox should be designed to allow for DSS participants to apply for exemptions or modifications to the broadest possible range of existing rules and laws, where necessary for the specific business case and where appropriate risk mitigants are in place.

Although the initial focus of UK authorities appears to be on the testing of a DLT infrastructure for FMIs performing both trading and settlement functions, AFME considers that there is scope to explore more transformational evolution of the capital markets ecosystem – whereby new types of FMIs such as those using DLT or other technologies allowing a distributed environment conform with global principles (PFMIs) and have central governance frameworks which satisfy regulatory requirements and appropriately defines roles and responsibilities, but distribute the operation of the market infrastructure in a way which creates efficiencies and reduces risks.

Ultimately, we consider the DSS as an important component of the broader development of DLT-based capital markets, and encourage authorities to consider how the DSS interacts with other initiatives both in the UK and abroad, including the development of legal and prudential treatments of crypto-assets.

Association for Financial Markets in Europe
London Office: Level 10, 20 Churchill Place, London E14 5HJ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 883 5540
Frankfurt Office: Neue Mainzer Straße 75, 60311 Frankfurt am Main, Germany T:+ 49 (0)69 710 456 660
www.afme.eu

Chapter 2 - Digital Securities Sandbox: Key Features

Assets in Scope

1. Do you agree with the broad approach set out above to digital securities in scope of the DSS? Please outline any comments or concerns as part of your answer.

Yes. We are generally supportive of the proposed scope of instruments.

We emphasise that it is important the statutory instrument sets out a precise scope of assets and bases this on an existing taxonomy of instruments in current UK legislation, such as the FSMA Regulated Activities Order (RAO), with specific references to specified investments and having as wide a scope as possible.

Further, we advocate that the DSS allows the issuance of securities denominated in non-sterling currencies. We note that experimentation to date, such as issuances by the European Investment Bank, has been in a variety of currencies (including GBP, EUR and SEK). Given the global profile of UK capital markets, limiting the DSS to sterling only would reduce the attractiveness of the Sandbox and we would consider it a missed opportunity.

Separately, we believe it would be helpful to explicitly clarify that the use of DLT or other novel technologies for the recording of assets on an internal 'books and records' system falls outside the scope of the DSS, on the basis that this does not fundamentally change the nature of the assets recorded.

Securities recorded in this manner are still held by the financial institution in the omnibus account of the financial institution at the relevant CSD, and the legal properties and risks associated with such securities have not changed. Similarly, cash recorded in this manner still represent deposit liabilities of the financial institution to each of its customers, and the legal properties and risks associated with such deposits have not changed.

While technically digital book entries on such internal DLT or blockchain based books and records system may be "tokens," such tokens operate in the same manner as traditional digital book entries, cannot leave the financial institution's internal books and records, and are meaningless and worthless outside of the financial institution's books and records.

Accordingly, in keeping with the HM Treasury's principle of "same activity, same risk, same regulation," such digital book entries should not be considered digital assets or crypto assets as defined in paragraph 1.3 or security tokens as defined in paragraph 1.22, and the current rules governing settlement should apply to a DLT books and records system in lieu of "digital settlement" contemplated under paragraph 1.24.

2. What specific kinds of digital securities/asset classes should be considered for inclusion in the DSS?

We would welcome the broadest possible scope of assets to be included. For example, if the scope is linked to the FSMA RAO, we would suggest explicitly scoping in:

-Shares, as defined in Article 76 of the RAO
-Instruments creating or acknowledging indebtedness, as defined in Article 77 of the RAO
-Government and public securities, as defined in Article 78 of the RAO
-Instruments giving entitlements to investments, as defined in Article 79 of the RAO

-Certificates representing certain securities, as defined in Article 80 of the RAO
-Units in a collective investment scheme, as defined in Article 81 of the RAO
-Other fund types, including Real Estate Investment Trusts (REITs)[1]

In terms of digital securities, clarification would be welcomed that this includes both bearer securities and registered securities, the latter of which can be held via a registrar connected to the DSS.
Equally, it should be possible to issue natively digital securities without the need for a paper certificate.

3. Do you have any novel use cases or use cases for non-systemic asset classes that you wish to discuss with regulators? Have you identified any regulatory adjustments required to support these use cases?

N/A – AFME intends to leave this for individual firms' responses.

Activities, Designations and Authorisations

4. Do you agree with the broad approach to activities, designations and authorisations in the DSS as outlined above? Please explain your answer.

We generally believe the scope of activities permitted in the DSS is an appropriate starting point, and we welcome the approach set out by HMT.

We recognise the DSS as an important step towards facilitating innovative use of DLT within UK capital markets, and we encourage that HMT consider building on this through expanding the scope of the DSS, or the future development of further sandboxes, which may allow the industry to explore further transformation of the capital markets ecosystem. Regulatory initiatives which embed traditional incumbent market structure and participant roles into its legislative framework may limit the possibility for financial market participants to innovate.

In order to position the UK as an innovative jurisdiction allowing market participants to trial new approaches to capital markets issuance and distribution, then a future Sandbox should allow market participants that are not FMIs to explore different configurations, without the need for existing market infrastructures, but still in accordance with the PFMI and IOSCO principles.

The opportunity to distribute functions amongst market participants that are currently provided in a centralised manner by market infrastructures - and therefore subject to single point of failure risk - should be explored further, given the benefits this could create in terms of increasing efficiency and mitigating financial stability risks. A future sandbox should allow participants to explore whether alternative structures can be developed, for example: a licensed DSS in charge of governance and oversight while the processing/operational tasks are distributed among participants.

In cases where the core activities of a DSS are "unbundled" or "distributed", or performed by different parties, specific attention should be given as to how to implement an overarching control function responsible for governance and access to the network, which establishes, monitors and assesses compliance with standards for participation in the network, as well as regulatory and supervisory interaction. These activities should also be established to follow the PFMI and IOSCO principles, where applicable.

[1] Depending on the structure of the fund, this may be covered under Article 76 or Article 81 of the RAO

Separately, we note that paragraph 2.4 refers to FMIs being "able to use digital asset technology in a way that is compatible with existing legislation". We would welcome further engagement with HMT on how this might be demonstrated.

5. Do you have any comments or concerns with the process outlined in Annex A?

Non-DSS Activities

6. Do you agree with the approach to non-DSS activities outlined above? Please explain your answer.

Further consideration is required on the impact of existing legislation being applied to non-DSS activities performed in relation to DSS assets. As noted by HMT, modification of this legislation is outside the scope of the powers provided to HMT by FSMA 2023. However, application of certain provisions in their current form to DSS assets, may limit the 'usefulness' or 'usability' of said DSS assets, and thus the overall attractiveness of the Sandbox.

For example, UCITS and AIFMD regulation triggers certain safekeeping obligations for assets that are deemed to be "financial instruments held in custody". Other assets are subject to a lighter touch verification/record-keeping requirement. It is unclear whether the more onerous safekeeping requirements could be complied with for DSS assets. A second example might be the capital treatment of assets (including client money) held in the DSS FMI.

We believe it is likely that many further potential frictions could emerge in a live environment, as has been the case with previous sandboxes.

AFME encourages UK authorities to consider an intermediate approach which provides for increased flexibility, through the provision of additional regulatory guidance, waivers or amendments where required.

This should potentially include bringing further pieces of legislation into the scope of the sandbox, as envisaged by HMT in paragraph 2.49

Separately, further consideration should be given to the ability to use DSS securities outside of the Sandbox – e.g. to be posted as collateral or in repo transactions. Generally, AFME members consider that the more that DSS securities have the same functionality as traditional equivalents, the more attractive they will be. AFME supports the principle of 'same risk, same regulatory outcome', and that the longer-term framework should apply a consistent approach to regulating different types of asset. This consideration must be balanced against the need to provide flexibility in the Sandbox environment.

Limits on DSS assets and activities

7. Do you agree with the broad approach to capacity and limits in the DSS described above? Please explain your answer.

AFME members are supportive of the proposed flexible approach which does not pre-determine definitive thresholds per asset class or entity.

We note that the determining thresholds on a case-by-case basis is likely to be a complex process. It is important that authorities are sufficiently resourced to process applications and determine appropriate thresholds in a reasonable timeframe, to maintain interest and momentum in the initiative.

We support the principles set out by the regulators to ensure the apportioning of thresholds is done in a fair manner which does not favour the earliest entrants, and allows flexibility as the Sandbox progresses. To facilitate this, we believe it is essential that some level of transparency is provided as to the methodology for determining appropriate thresholds, and we look forward to the FCA and Bank of England providing further detail on this point.

We note that the level of engagement and interest in the DSS is likely to depend on some degree of transparency regarding potential limits, in order to help potential DSS entrants to determine the commercial viability of a particular project before proceeding with an application.

Further, we are supportive of allowing thresholds to be increased upon the successful testing of a model within a specific threshold. Ensuring this type of sufficient flexibility would also allow for a smooth transition into a post-DSS environment, following the successful demonstration of an appropriate use case.

8. What size of activity does an FMI in the DSS need to reach in order to be commercially viable? Please note if there is any sensitivity in sharing information here.

This may vary significantly depending on the design and set-up of each use case. As a comparison, we note that the limits imposed in the EU DLT Pilot Regime, an analogous initiative, are generally considered to be significantly too low and may limit the scalability of certain projects.

Eligibility to Participate in the DSS

9. Do respondents agree with the approach to eligibility outlined above? Please explain your answer.

We are supportive of HMT's proposal to consider applications from groups of entities under a single MTF/CSD arrangement. As previously set out in AFME correspondence with HMT, we believe that it should be possible to create an FMI where there is a centralised governance model but decentralised operations, which is fully compliant with the Principles for Financial Market Infrastructure (PFMIs).

Authorities should also take into consideration the track record and standing of the entity applying to participate in the DSS, including its current supervisory arrangements, levels of consumer protections, bankruptcy remoteness provisions, AML processes and capitalisation requirements.

10. Will participating entities be comfortable demarcating Sandbox from non-Sandbox business?

Applying to Participate in the DSS

11. Do you agree with the approach to applications outlined above? Please explain in detail any issues or concerns.

AFME members have not identified any material issues or concerns with the approach outlined above.

It would be helpful to clarify that applications from the UK branch of an entity incorporated in a foreign jurisdiction are permitted.

12. Do you have a preference on the timeframes within which applications can be made?

N/A – AFME intends to leave this for individual firms' responses.

Legislative Modifications

13. Do you agree with the approach to legislative modifications and regulator rules outlined?

We support the proposal to identify and amend up front any known regulatory barriers to innovation. We believe this should be supported by ongoing flexibility for DSS participants to apply for exemptions / modifications to any existing rule or law, providing justification as to:

- why the exemption or modification is critical to the specific business case of the participant;
- what alternative measures the participant will put in place to achieve the same policy objective of the original rule or law;
- how the new FMIs configurations adhere to the PFMIs

AFME considers that it would be helpful if a list of regulatory exemptions or amendments which have been granted to successful DSS applicants is made publicly available. This could also include details on how the DSS FMI will ensure any risks arising from the exemption/amendment is appropriately mitigated.

We note that HMT envisages some potential overlap between legislation in scope of the DSS and legislation that may be repealed as part of the 'Smarter Regulatory Framework' initiative. We welcome that this should not disrupt the operation of the DSS – e.g. if a DSS FMI has been granted exemptions or amendments from certain requirements, these should continue to apply even if the original requirement moves from legislation to an FCA or PRA handbook. Further clarification on how this will be achieved is welcome.

With respect to settlement finality designations, AFME believes that both options outlined in paragraph 2.63 should be considered, and that it is left to DSS applicants to request either temporary designation or full exemption.

14. What other specific regulatory barriers have you identified to the use of digital securities within markets, either in relation to the legislation above or generally?

In addition to those identified by HMT in the consultation paper, AFME believes that the following regulatory requirements should be considered for exemption and/or modification.

UK CSDR

- Dematerialised form definition (Article 2(1)(4))
- Transfer orders definition (Article 2(1)(9))
- Participant definition (Article 2(1)(19))
- Securities accounts definition (Article 2(1)(28))
- Outsourcing of a core service to a third party (Article 19)
- Requirements for participation (Article 33)
- Transparency (Article 34)
- Communication procedures with participants and other market infrastructures (Article 35)
- Segregation of assets (Article 38)
- Provision of ancillary banking services (Article 54) – specifically the requirement to set up a standalone bank, which would represent a major barrier to the development of any DSS FMI. Given the limits on activity within a DSS FMI, we do not believe this provision is necessary.

UK MiFID

- Specific requirements for MTFs (see UK implementation of Article 19(2) EU MiFID)
- Access to a regulated market (see UK implementation of Article 53(3) EU MiFID)

UK MiFIR

- Transaction reporting Article 26 MiFIR

15. Are there any pieces of legislation in addition to the above that should be brought into scope of the DSS (either listed in the FSMA 2023 as "relevant enactments" or outside of this)?

AFME supports the maximum possible flexibility for the DSS, and believes it is highly probable that additional legislative or regulatory barriers may be identified as DLT-based experimentation continues. We therefore welcome express clarification in the final statutory instrument that the government also retains the ability to bring further pieces of legislation into scope of the sandbox on an ongoing basis.

Duration

16. How long are participating entities likely to need in the DSS?

N/A – AFME intends to leave this for individual firms' responses.

17. Is five years an appropriate timeline? Should it be longer or shorter if not? (note that we anticipate entities exiting the DSS before the overall timeline expires)

Exiting the DSS

18. Do you agree with the approaches to exiting the DSS outlined above?

Although some level of risk and uncertainty is implicit in participating in the Sandbox, AFME members remain concerned that a lack of clarity on the exit process will hinder the attractiveness of the Sandbox.
AFME therefore welcomes the aspiration of UK authorities to ensure a smooth transition away from the DSS, and will not be a "bridge to nowhere". We also welcome the clarification that the permanent amendments to the legislative framework will be enacted prior to the end of the Sandbox's lifecycle. In practice, it will be important that there is ongoing engagement between authorities and DSS participants as the Sandbox develops, and authorities develop their thinking on what permanent legislative amendments are likely. We note that HMT propose the power to extend the Sandbox indefinitely, which we caution against It is important that DSS-authorised FMIs can transition to post-Sandbox activity smoothly and with some degree of certainty about the duration and timing of the DSS.

We note that DSS applicants are required to provide details of an 'exit strategy' as part of the application process. Our view is that this may not be possible for applicants to fully define, as it may be in part dependent on factors beyond their control. For example, the means by which DSS assets could be transitioned or otherwise wound down may be contingent on further clarification as to the legal status of those assets (e.g. enactment of the recommendations of the Law Commission, see our response to Q36)

Further, we note that DSS FMIs will require full designation under settlement finality regulations in order to exit the Sandbox. As noted in paragraph 2.62, the purpose of the SFRs is to mitigate the potential systemic impact of a participant in a system becoming insolvent. Regulators intend to apply limits to each individual entity participating in the DSS, as well as an overall 'capacity' at asset class-level, in line with financial stability objectives. On that basis, some members express the view that DSS FMIs are unlikely to be of systemic importance immediately upon exiting the sandbox, and as such a this requirement may not be appropriate or necessary.

Supervision and Enforcement

19. Do you agree with the approach to supervision and enforcement outlined above? Please explain your answer.

As noted elsewhere in our response, we are supportive of the dynamic nature of the proposed DSS, but wish to highlight that this approach may require significant resourcing by authorities. In particular, we note that FMIs operating a combined TSS will require supervision by both regulators, and will require careful coordination to avoid undue delays to projects' development.

20. Is there any information that will be sensitive to share with the government regarding the operation of a DSS FMI?

Digital Cash/Payment Leg

21. What features do industry require from a money settlement asset in the DSS and why?

We note that the consultation only makes explicit reference to "tokenised commercial bank deposits". We would welcome more clarity on what instruments are included within that category, which we understand to include deposit tokens. We support the maximum possible flexibility for money settlement assets. This could include "on-chain" payment assets backed by commercial or central bank money, or "off-chain" solutions. We believe that the Sandbox should allow sufficient flexibility for participants to determine which solution to use for the payment leg, as long as that is appropriately regulated, clearly established upfront and disclosed in a transparent way to all participants in the system. With respect to central bank money solutions, if and when they are available, we believe it would be helpful to clarify that any relevant CBDC may be used as a money settlement asset, and this would not be limited to CBDC issued by the Bank of England.

We note that UK authorities have been at the forefront of innovation with respect to experimentation with "on-chain" money settlement assets. Where possible, we encourage enabling links between these initiatives and the DSS.

AFME is of the view that it should not be necessary to rely heavily on the ancillary banking provisions of CSDR and the related RTS, which require a CSD to be authorised as a credit institution or to designate a standalone third party credit institution, which would entail significant costs and could limit the flexibility of potential payment rails and impose a high threshold for participation, particularly when those FMIs would not be systemic.

Chapter 3 – Further Policy Issues

Technology Considerations

22. What type of DLT system are you planning to use (permissioned or permissionless), and what trade-offs have you considered in your decision?

N/A – AFME intends to leave this for individual firms' responses.

23. How can settlement systems based on permissionless DLT be designed in a manner that would meet the PFMIs?

Reporting

24. What benefits could entities using digital asset technology offer when meeting regulatory reporting requirements?

DLT-based regulatory reporting could enable embedded supervision, where supervisors automatically monitor compliance of DLT-based positions and transactions in real time via a node on the distributed ledger. The single source of truth and accompanying data transparency of DLT could reduce the currently heavy manual and operational processes required to record and report regulatory data. Embedded supervision's impact on broader regulatory reporting could be limited until industry and regulators align on approach to realising three enabling conditions: (1) interoperability among distributed ledgers and with the broader market data; (2) legal guarantee of the integrity of DLT-based Securities; (3) an established definition of settlement finality, so that the data presented to supervisors is not subject to change

25. Are there any aspects of the existing regime that would prevent effective reporting in the context of digital securities?

Further consideration should be given as to whether existing regulatory reporting requirements including MiFIR transaction reporting are appropriate for transactions executed and settled in a DSS FMI As noted in our response to question 24, DLT could offer the possibility of a much more efficient regulatory reporting regime, and it would therefore seem unnecessary to 'bake in' burdensome legacy processes. We further note that due to the high degree of regulatory scrutiny that is expected for DSS assets, as well as the existence of prescribed limits on levels of DSS activity, such activity will therefore have a very low level of financial stability risk. This significantly reduces the need for additional regulatory reporting.

Custody

26. How do potential DSS entities intend to carry out custody functions in relation to activities in the DSS?

We believe it is unlikely that a single model for custody will emerge in the DSS, mirroring the optionality that exists today for traditional securities. These models today include direct custody, sub-custody, and global custody arrangements. A critical feature of the custody chain for traditional securities is the use of omnibus accounts, whereby an account operated by an intermediary can hold securities of multiple underlying investors. We note that this model should be legally, operationally and technologically feasible in a DLT environment, without negatively impacting the safety of clients' assets.

Whilst we acknowledge the future development of prudential rules for custody of tokenised securities is outside the scope of the Digital Securities Sandbox, we wish to note our belief that UK policymakers should take an off-balance sheet approach to custody of tokenised securities as set out in the Basel Committee's standards on the prudential treatment for banks' exposures to cryptoassets. It is essential that any capital and liquidity requirements associated with cryptoasset custody do not make custody unfeasible at scale for banks.

27. Are there any changes to the existing custody regulatory framework (including FCA rules, Article 40 of the RAO and CASS) that would facilitate the safe operation of these functions?

With respect to CASS, we believe that the following requirements may be particularly problematic. Please note that this is not a comprehensive list and the application of these requirements may vary depending on the particular model of a platform.

- CASS 6.6 – sets out various requirements on records, accounts and reconciliations which it will not be possible to comply with where a tokenised security is custodied. These rules generally assume that the relevant securities are recorded on a CSD rather than on DLT which means that the segregation, account reconciliation and record keeping requirements are either not possible to be met and/or would not meet the purpose of the requirements.
- CASS 6.2.3 – which requires a firm to effect appropriate registration or recording of legal title of an asset that is custodied and provides for a waterfall of permitted names for registration. In respect of natively issued tokenised securities can only be registered in the name of the noteholders directly on the platform – so it's not clear what the purpose of this requirement would be.
- CASS 6.3 – there are various rules that apply to "depositing assets" and "arranging for assets to be deposited" with third parties. Although we support the potential to sub-custody tokenised securities, certain of the terminology in CASS 6.3 does not naturally fit with tokenised securities and certain of the provisions (for example, those that refer to requirements to use local CSDs) would be difficult to reconcile with a digital securities platform.

As a general comment, the complexity inherent in the variations of cryptoassets (including tokenised securities), and the different applications of DLT (permissioned, permissionless etc), mean delivery of custody services for these assets has more unique considerations than for traditional assets. In this case, regulatory principles and standards – rather than detailed and prescriptive rules which may need to be adjusted with use cases—can help to achieve regulatory outcomes.

As previously flagged in our engagement with HMT, several issues are likely to arise in relation to the definition of 'custody' in a DLT context, including distinctions between legal and beneficial ownership, and operational and governance controls in relation to private keys. In this regard we would welcome further engagement with UK authorities to help further identify where there are likely to be issues in applying existing

custody rules, including CASS, to new DLT-based business models that introduce features such as tokenised assets and omnibus wallets.

Retail Users

28. If you envisage retail investors interacting with investments traded on DSS entities, how would this differ from more traditional models?

N/A – AFME will not respond

29. Do you see any UK rules or requirements as obstacles to this model?

N/A – AFME will not respond

Taxation

30. How would an entity operating an FMI in the DSS ensure that the tax obligations of its users are being fulfilled?

It would be helpful if HMT were to clarify and confirm that all existing procedures, processes, reliefs and exemptions that currently apply in respect of Stamp Taxes on Shares (STS) for those securities within the scope of stamp duty and stamp duty reserve tax (SDRT) when settled on an existing FMI operating outside of the DSS, will continue to apply and be observed by HMRC for those securities settled on an FMI operating inside the DSS, specifically the charge under and practice around section 96 of the Finance Act 1986 (FA 1986), on the basis the platform within the DSS is a clearance service or depositary receipt system for the purposes of s96(1) FA 1986.

Additionally, AFME members have mixed views on how UK tax obligation of users of an FMI operating inside the DSS would or should be fulfilled. Some noted they were unclear to what extent HMT expects FMIs operating in the DSS for traditional securities to be responsible for ensuring that its users comply with their tax obligations.

Other members noted they would expect stamp duty/SDRT obligations of relevant users to be fulfilled in the usual way, namely that there would be an operator of a relevant system (i.e., for the purpose of Stamp Duty Reserve Tax Regulations 1986 (SI 1986/1711)) who would be responsible for calculating, collecting and accounting any stamp duty and SDRT to HMRC (e.g. as Euroclear UK & International (EUI) as operator a CREST securities settlement system does for on-market transactions in UK equities today).

31. What issues could be created by the application of existing tax procedures to assets settled via FMIs in the DSS?

If there is an operator who is the accountable person (or otherwise responsible for) for collecting and paying any stamp duty and SDRT to HMRC , then presumably accounts will need to be set up to facilitate that process, which might take some time. It is also noted that the Retained EU Law (Revocation and Reform) Bill 2022 if enacted in its current form, might have the effect that the current HMRC existing practice in relation to the 1.5% charge (that is, HMRC will not seek to collect the 1.5% charge that might otherwise arise on the issue of chargeable securities into a clearance service or depositary receipt system) will cease to apply with effect from 1 January 2024. If this happens, and the charge is applied from 1 January 2024, then existing tax procedures that are replicated now for FMI within the DSS, might not be relevant or be suitable for all types of assets settled on an FMI in the DSS from 1 January 2024.

Cross-industry collaboration

32. How should information regarding DSS activity be shared with the wider financial services sector?

It would be beneficial to make public the lessons learned from the sandbox on an ongoing basis. However, no private or proprietary information should be disclosed as this would discourage participation.

For example, we consider that it may be helpful for the wider financial services sector to be made aware of:

- Any additional regulatory exemptions or amendments which have been granted to successful DSS applicants.
- What limits have been imposed on successful DSS applicants.

33. What information will be sensitive for a DSS entity to share with others across the FS sector?

34. Would a cross-industry body, set up to scrutinise DSS activity and provide policy recommendations, be appropriate? If so, how should this be set up, and who should participate?

A cross-industry body incorporating both public and private sector could be created to explore further policy options that could contribute to financial stability, system risk reduction and further explore necessary changes in an increasingly digital world.

We note that coordination will be required on a global level. Firstly to harmonise regulatory and legal frameworks, and secondly for industry to develop common standards that enable interoperability within DLT-based markets and with traditional infrastructure.

International coordination

35. What frictions might hinder the use of digital assets on a cross-border basis?

Globally, existing regulation of DLT-based securities is not harmonised, and does not set out a clear and complete regulatory framework that is comparable across jurisdictions. We believe that this may hinder the growth and development of DLT markets and could undermine investor confidence.

The GFMA report on the Impact of DLT in Global Capital Markets[2] sets out four key areas in which global regulators and policymakers should focus collaborative efforts on:

1. Scope of Risk: Regulators should work to understand the distinction between DLT, the technology, the use cases built on top of it, and the risks DLT poses. Like a traditional database model, there are ways to develop DLT environments to be more controlled—not only to comply with existing regulation but also to make such compliance more seamless, comprehensive, and effective.

2. Intermediary Regulation: Digital asset markets have developed without a clear way for regulated intermediaries to participate; thus, clarity needs to be provided to allow regulated intermediaries to participate in digital asset markets.

3. Infrastructure Regulation: Regulators should require entities that engage in Clearing and Settlement, payment activities for DLT-based Securities, and DLT-based Payment Instruments transactions to be subject to regulation and supervision; where necessary, the existing framework should be adapted to allow regulated entities to participate in digital asset markets.

4. Custody Standards: Clear standards are needed to ensure that assets are custodied by regulated entities in a manner that is safe, with property rights that are clear and well disclosed. Users should have the option of using regulated entities, such as banking organisations for such services. Without rationalising accounting and regulatory standards, participating in such activities at scale would be too costly for most banking organisations, which are often the favoured choice of the market to serve as independent custodian.

Chapter 4 – Legal Considerations

English and Welsh Law

36. Following the conclusions of the UKJT statement, what further action (either public or private sector led) needs to be taken to provide clarity regarding use of digital securities, as well as digital assets more generally?

AFME members consider that the work of the UKJT and Law Commission represent positive steps forward in the development of digital assets markets. We are broadly supportive of their approach. We note that the Law Commission's final report[3] sets out a number of recommendations, including legislative amendments to UK company law (see paragraph 8.87) and categorisation of objects of personal property rights (see paragraph 3.76).

[2] https://www.gfma.org/policies-resources/gfma-publishes-report-on-impact-of-dlt-in-global-capital-markets/
[3] https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2023/06/Final-digital-assets-report-FOR-WEBSITE-2.pdf

We consider that it would be beneficial for these recommendations to be fully resolved before the anticipated conclusion of the Sandbox.

Typology of Digital Securities

37. Do you agree with the categories above?

Yes. The typology used by HMT is consistent in principle with the categorisation set out in the GFMA report on the Impact of DLT in Global Capital Markets, although the terminology used is slightly different.

1. "Tokenised Securities", which are issued and custodied traditionally, but also converted onto a distributed ledger through a digital twin token that represents the underlying traditional security; and
2. "Security Tokens", which are issued and custodied natively on a distributed ledger only, and therefore do not have a traditional security as an underlying basis

38. Into which category will your proposed use-case sit?

N/A – AFME intends to leave this for individual firms' responses.

Jurisdiction /choice of law

39. What conflicts of law issues are likely to arise in the DSS? How should these be mitigated?

40. We intend that applicants to the DSS should be required to confirm English and Welsh law as the choice of law. Applicants should also agree that England and Wales will be the choice of jurisdiction in the event of a dispute. Do you agree? If you disagree, please explain why

AFME members have not identified any material issues or concerns with the approach outlined above.

AFME Contacts
Pete Tomlinson
Director, Post Trade
peter.tomlinson@afme.eu
+44 (0)20 3828 2684